



The Nepal Stock Exchange - A Review

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1. EXECUTIVE SUMMARY

This section summarizes the findings of the present review and the recommendations made under each section of the report.

A. New Issue Guidelines

Findings

- The New Issue Guidelines outline the Exchange policy on the conduct of public share issues by either listed or potential listed companies.
- The scope of the guidelines adopted extends well beyond its usually intended objectives and addresses issues pertaining to listings and prospectus requirements.
- The guidelines have been adopted by the Securities Board instead of the Exchange.

Recommendations

- Section 9(a) which restricts new issue management to members of the Exchange should be deleted to provide for wider participation in such activities.
- Section 8(b) conflicts with Section 10(c). Section 8(b) should be deleted, subject to a suitable amendment to the Companies Act, since it promotes partly paid shares which restricts free transferability.
- The period permitted for the finalization of the allotment should be further reduced from the seventy-five days mentioned in Section 17(c).

B. Amendments to the Memorandum of Association

Findings

- The recent amendments to the memorandum of association convey the rule-making capability to the NEPSE.
- NEPSE appears to lack initiative in creating conditions conducive to an efficient marketplace.

Recommendations

- NEPSE should initiate steps to promulgate listing, continuing listing and additional listing requirements as an immediate priority.
- NEPSE should initiate steps to formalize more broader 'Member' participation in the policy making process.
- The requirements for the preparation of the 'prospectus', which the Securities Board has attempted to address partially in the New Issue Guidelines, should be a separate section in the Exchange rules.

C. Demarcation of the Regulatory Responsibilities of NEPSE and the SEB

Findings

- Even after eighteen months of operations, the two regulatory authorities in Nepal have not yet clearly defined their responsibilities in regulating the market.
- Functions which could be more effectively and efficiently carried out by the Exchange have been vested with the Securities board.
- The approval of mutual funds, which are capital market institutions, is carried out by the Rastra Bank under the Finance Act.

Recommendations

- The Securities Board should serve more as a supervisory capacity, providing oversight regulation and setting the standards for the development of the market. Their activities should include:
 1. Formulating regulations for the licensing of the Exchange. Such regulations should stipulate the rules that the Exchange should have in place for the efficient and transparent conduct of the market.
 2. Regulating the licensing of Exchange members and the renewal of such licenses. This will require an amendment to the Securities Act.
 3. Regulating the licensing of other market intermediaries such as underwriters, issue managers, share registrars, etc.
 4. Regulating the licensing of unit trusts and mutual funds and the regulation of their activities on a continuing basis. This will also require an amendment to the Securities Act.
- The functions of the Exchange is more hands-on by nature. The Exchange should adopt the necessary rules for
 1. Admission of companies.
 2. Listing of securities.
 3. Additional listing of securities.
 4. Monitoring of listed company activity on an on-going basis (continuing listing requirements).
 5. Code of ethics for the members of the Exchange.
 6. Guidelines for the conduct of new issue of securities.

7. Disclosure standards for the preparation of the offer document (prospectus).

All such rules should be approved by the Securities Board as part of the licensing procedure of the Exchange.

D. Amendments to the Securities Regulations

Findings

- The amendments to the regulations proposed by the Securities Board will further involve the Board in operational aspects of the stock market which should be left to the Exchange.
- Proposed amendment 19(a), while making underwriting mandatory to certain entities seeking a listing, restricts the involvement in such underwriting activity to the market makers.
- Proposed amendment 19(b) attempts to restrict issue management activity to the members of the Exchange.
- Proposed amendment 27A(5)b permits the listed companies to reject the registration of share transfers in instances where the quantity is less than the minimum board lot.

Recommendations

- Proposed amendments 19(a), 19(b) and 27A(5)b should be deleted.
- Most of the sections in the securities regulations which relate to operational aspects of the stock market may have been adopted by the Securities Board when NEPSE did not have a sufficient legal base for rule making. Now that this has been rectified, such provisions should be repealed from the securities regulations, paving the way for the Exchange to adopt appropriate rules.
- Such deletions are as follows:
 1. Sections 22 to 27 (Chapter 5) relating to the listing of securities
 2. Sections 28 to 34 (Chapter 6) relating to the membership rules of the Exchange
- Membership rules of the Exchange should subject the admission of new members to the granting of a license by the Securities Board. This would require an amendment to the Securities Act.

E. Market Structure

Findings

- The market structure has undergone very few changes since May 1994.
- The member firms of the Exchange have formed themselves into an association.
- The market-makers have failed to meet the expectations of the Exchange.
- A crisis situation has developed in the NCM first mutual fund.

Recommendations

- Extend assistance to the brokers association to further its activities.
- Convert the market-making companies at NEPSE into brokering firms, as the necessary pre-conditions for the operation of market-makers do not exist in Nepal.
- Convert the open-end NCM first mutual fund to a closed-end investment fund which could be listed at the Stock Exchange.
- The Exchange should adopt a set of rules for the listing of Investment Funds prior to listing any closed-end funds.
- Convene a meeting of the unit holders of the mutual fund to seek their approval for such a conversion.
- Buy back the units of the dissenting unit holders at the purchase price in view of the repurchase obligation cast on the management company.

F. Institutional Investors

Findings

- Participation of institutional investors in the stock market in Nepal is rather minimal.
- The current interpretation of capital gains for taxation purposes could be a contributory factor.

Recommendation

- Consider the exemption of capital gains derived from stock market from taxation.

G. Market Operations

Findings

- A noticeable improvement is evident in the post-trade processing capabilities of the Exchange due to the computerized record-keeping introduced recently.
- No progress has been made by the Exchange in the monitoring and surveillance of members and listed companies.
- No meaningful headway has been made by the Exchange in defining clear-cut job descriptions for its staff, resulting at times in under-utilization of the available human resources at the Exchange.
- The Exchange involvement in the business activities of certain member firms, due to historical reasons, has created concern among the Exchange membership on the ability of the Exchange to create a level playing field for all market participants.
- Conflicts of interest could also arise if multiple functioning is permitted in the areas of stock brokering, portfolio management and market-making, unless proper safeguards are established prior to permitting such multiple functions.

Recommendations

- The Exchange should identify personnel with the correct temperament for the senior management positions at the Exchange.
- Clear job descriptions should be developed for such positions.
- Once the correct personnel are identified, these managers should be placed with another Exchange from the region to serve internships in their areas of operation.
- The Exchange should divest its shareholdings in other companies to avoid conflicts of interest situations which undermine its position as an effective market regulator.
- In instances where members of the Exchange function as auditors of listed companies, such broker members should be precluded from acting as stock brokers for these companies.
- The Exchange should consider levying an entrance fee for a seat on the Exchange from all future entrants.

2. PREAMBLE

As part of the economic liberalization program in Nepal, the securities market was restructured in May 1993 by the creation of the Nepal Stock Exchange (NEPSE) and the Securities Board. NEPSE, the successor to the Securities Exchange Centre (which was in existence since 1976), was intended to assume a lead role in the activities more confined to the operation of the securities market, while the Securities Board was created to function as the body responsible for the oversight regulation of the securities market. In the absence of an active private sector participation in the economy and a broker dealer community during the tenure of the Securities Exchange Centre, the ownership of the Exchange remained with the government and continued in the same manner even after the restructuring, unlike in most other emerging markets. Trading during this period was mainly confined to government bonds, and transactions were concluded with the intermediation of the officials of the Securities Exchange Centre.

The government of Nepal, through the United States Agency for International Development, requested assistance from the IRIS Center at the University of Maryland to set up a Stock Exchange under the new structure. Subsequent to an initial review undertaken in June 1993 the IRIS center recommended, for the future development of the stock market in Nepal where it could play a pivotal role in a market-based economy, that:

- **the market regulatory structure be modified with the NEPSE functioning as a self regulatory body and the Securities Board providing oversight regulation;**
- **public share trading be introduced with the intermediation of broker dealers;**
- **proper systems and procedures be introduced for the trading, trade processing and market surveillance at NEPSE;**
- **a set of rules be introduced for the admission, listing, continuing listing and the additional listing of companies;**
- **a detailed organisation structure be formulated with clearly defined job descriptions to meet the future challenges facing NEPSE.**

In January 1994 NEPSE opened public share trading based on the open outcry system with twenty five brokers and three market-makers. The initial improvement of the transparency of operations at the Exchange with its restructuring generated an interest among the investing public in Nepal, and NEPSE experienced a substantial increase of activity both in the primary as well as the secondary markets. A number of companies had successful initial public offerings, with the share issues oversubscribed on many occasions. The lack of an adequate supply of shares in the market resulted in overheating of share prices at NEPSE, creating concern among the authorities in Nepal, and IRIS was requested in May 1994 to review the post public share trading developments in Nepal. The study revealed that the regulatory authorities in Nepal had made

little headway in orchestrating the desirable changes suggested earlier to complement the public trading environment. The demarcation of responsibilities between the NEPSE and the newly created Securities Board remained unresolved, creating confusion among the market participants. The outdated Companies Act of 1964 and the Securities Act of 1983 were of little assistance to the authorities in initiating corrective action.

Although new regulations under the Securities Act have been formulated since the inauguration of NEPSE, they have contributed little to the meaningful development of the regulatory structure due to deficiencies in the enabling legislation of 1983. The NEPSE lagged behind in implementing the standards and procedures to support the market operations, due to the absence of a proper legal basis at the Exchange for their adoption. As a result, due to the lack of proper disclosure by listed companies and the lack of proper regulation by the Exchange, the market was mainly rumor-driven. This led to the creation of conditions conducive to benefit a privileged few, rather than creating a level playing field that would benefit a greater majority. The delay in implementing the necessary standards and procedures resulted in a backlog in post-trade processing, and long delays were experienced in completing public share issues. Based on these findings, the IRIS review of May 1994 recommended the following:

- 1. Adoption of appropriate listing rules to stipulate proper entry standards for companies approaching the Exchange;**
- 2. Adoption of appropriate continuing listing requirements to ensure timely disclosure of financial information and material developments in listed companies;**
- 3. Clear demarcation of responsibilities between the Securities Board and the NEPSE in the regulation of the market on the basis of self regulation and oversight regulation;**
- 4. Amendment of the Memorandum of Association of NEPSE to give the Exchange the ability to promulgate rules and regulations;**
- 5. Adoption of appropriate New Issue Guidelines to regulate the initial public offerings and eliminate delays encountered by the investing public in obtaining share certificates, refunds etc.**

The political developments in Nepal since November 1994, which resulted in uncertainty on future policy direction, had a rather adverse effect on the market. Both trading volume and turnover declined appreciably as the investor interest waned during this period.

3. TERMS OF REFERENCE FOR THE PRESENT ACTIVITY

The present report is the outcome of a study undertaken by IRIS under the following terms of reference:

1. A follow up evaluation of the present state of the capital markets based on recommendations provided earlier covering:
 - a) Policy changes such as New Issue Guidelines, amendments to the rules formulated under the Securities Exchange Act, amendments to the memorandum and articles of association of the Nepal Stock Exchange;
 - b) Operational system such as changes in the trading floor procedures, clearing and settlement system, corporate disclosure and market information, monitoring and surveillance; and
 - c) Market structure in terms of market intermediaries, institutional investors and their role and impact on the market development process.
- 2) Based on the review of the above areas, look into the adequacy of the policy measures and operational system and whether they are in conformity with international practices, and comment on the progress made towards implementation of previous recommendations.
- 3) Based on this assessment, identify problems, potential pitfalls, and areas of ongoing concerns such as the emerging trends like multiple functioning in areas of portfolio management, market-making and brokering by a single intermediary institution, brokers becoming a member of the board of the company or an auditor of the company.
- 4) To address these problems, provide recommendations on needed policy changes and regulatory measures, operational controls and improvements, and structural changes in the market.

Based on the above terms of reference, a review of the capital market activities with particular emphasis on operations at the Nepal Stock Exchange was undertaken from the 19-25 August 1995. Under this review the changes in the areas of policy developments, operations and market structure were examined, as most of the recommendations made in previous reviews relate to such areas.

4. REVIEW

4.1 Policy Changes

Policy changes since May 1994 are evident in the formulation of New Issue Guidelines and the amendment to the Memorandum of Association of the Nepal Stock Exchange. Further changes in policy are contemplated in the future with the proposed changes to the regulations formulated under the Securities Act.

4.1.1 New Issue Guidelines

In previous reviews, the formulation of New Issue Guidelines was recommended, to regulate the conduct of public share issues by companies applying to the Exchange for a listing of its securities. Such guidelines should outline the Exchange policy on the opening and closing of public share issues, distribution of offer documents, application procedure, allotment of shares in instances of over-subscription, refunding of subscription money and the eligibility to commence secondary trading.

The scope of the New Issue Guidelines adopted extends well beyond its usually intended objectives. While addressing the issues outlined above, an attempt has been made to address other issues pertaining to the Listing of securities and information disclosure in the Offer Document (Prospectus Requirements). Rules pertaining to Listings and Prospectus Requirements are areas which should be independent from New Issue Guidelines and should be dealt with separately.

The regulation of listed companies in the areas of listing (including guidelines for new issues), additional listing, continuing listing and disclosure standards, should be the responsibility of the Stock Exchange, as such activity is carried out by listed companies as part of their day-to-day operations. However, there still appears to be either a lack of understanding or a purposeful deviation from the adoption of principles of oversight and self-regulation in the operations of the stock market in Nepal. The absence of such principles is conspicuous when comparing with other developed and emerging stock markets. As emphasized in our earlier reports, the “Hands-On functions” in regulating a stock market are best left to the Exchange itself, while the “Oversight” aspects should be the prerogative of the Securities Board.

This lack of division of responsibilities in regulation is also evident in other areas of regulation of capital market operations, such as Unit Trusts and Mutual Funds. At present, mutual funds are approved by the Rastra Bank under the Finance Act. However, mutual funds, being capital market institutions, should fall within the purview of the Securities Board, and it should be the prerogative of the Securities Board to formulate rules for their approval and regulation. Such powers could only be vested on the Securities Board with suitable amendments to the Securities Act. Powers to license the Stock Exchange, stock brokers, and underwriters, and adequate provisions to deal with such abuses as insider trading, are other areas in which

suitable amendments should be made to the Securities Act. This would give the Securities Board the power to facilitate proper oversight regulation of the market.

In addition to the above, we wish to make the following observations on the New Issue Guidelines.

1. Section 9(a) of the New Issue Guidelines precludes corporate bodies other than those which have obtained membership of the Exchange from functioning as issue managers in a new share issue.

“ A corporate body must engage only a corporate body which has acquired the membership of the Stock Exchange to function as its issue manager”

The functions of an issue manager include the handling of all formalities connected with a share issue, including the preparation of the listing application to the Exchange, the preparation of the offer document, and the performance of all other back office work involved in a share issue. *Experience in stock brokering or market-making do not have any bearing on the efficient performance of such functions.* In other markets, these functions are performed by subsidiary companies of stock brokering firms, merchant banks or merchant banking arms of commercial banks, issuing houses, and secretarial firms which are in many instances offshoots of accounting firms. The above rule, while providing an unfair advantage to the two present members of the Exchange (NIDC Capital Markets and Citizens Investment Trust)--which perform the services of issue management to maintain their dominance in the market--will also prevent the issuers from receiving an efficient service through open and equal competition for such services in the market. **We would therefore recommend that Section 9(a) be deleted from the New Issue Guidelines.**

2. Section 8(b) precludes issuers from collecting more than 50% of the face value of the stock at the time of inviting applications.

“ No call for payment of more than 50% of the face value of the stock which is to be issued may be made while inviting applications”

Section 10(c) of the New Issue Guidelines requires companies applying for a listing to ensure unrestricted transferability of shares which are issued through the Exchange:

“ Arrangements for unrestricted transfer of shares”

In terms of Section 8(b), if the issuer is precluded from collecting more than 50% of the face value of the shares on offer, the shares will remain partly paid until the call for the balance 50% is made by the company. Although Section 8(b) conflicts with Section 10(c) it is consistent with the existing company law in Nepal, which precludes the issuers from collecting more than 50% of a share at the initial issue. As we have pointed out in our previous reviews, the issuing companies

have a lien on all partly paid shares, and until the share is paid in full such shares are not freely transferable. One of the cardinal principles in the operation of a Stock Exchange is the free and unrestricted transferability of all shares listed on the Exchange. Unless this is rectified by a suitable amendment to the Companies Act, the investors might face undue hardships in the future in obtaining valid legal title to the shares they purchase in the secondary market, thus negating the very purpose of the existence of such a market. **We therefore recommend that Section 8(b) be deleted from the New Issue Guidelines, subject to an appropriate amendment to the Companies Act.**

3. Section 17(c) of the New Issue Guidelines allows companies a period of seventy-five (75) days to finalize the allotment of shares and the refund of any excess money to the applicants. This period still appears to be far too long. The considerations in deciding this period are the uninterrupted flow of funds to subsequent issues and the secondary market, and the fact that the issue managers are prevented from receiving the benefit of applicant funds for an unusually long period of time. **We would therefore recommend that the further reduction of this period of time be considered by the relevant authorities in Nepal.**

4.1.2 Amendments to the Memorandum of Association of NEPSE

The amendments to the Memorandum of Association of NEPSE were suggested to provide NEPSE with the ability to promulgate rules to perform its regulatory functions effectively. This amendment was approved at a recent general shareholders meeting of the Exchange. NEPSE should now initiate steps to adopt the long-awaited rules on **Listing, Continuing Listing and Additional Listing Requirements**, and move away from the shadow of the Securities Board; it must be projected as an independent organization if it is to be viewed seriously by the market participants as an effective regulator of the stock market. As emphasized in many of our previous reports, rules and regulations are tools that would assist the management of the Exchange in carrying out its regulatory functions. Much will depend on the management's willingness to step out and regulate the market participants. This aspect had been seriously lacking in the NEPSE setup since the commencement of public share trading in January 1994.

A considerable amount of frustration and displeasure is evident among the membership of NEPSE, due to the failure of the Exchange to require and obtain corporate information from the listed companies on a regular basis, even after a lapse of eighteen months from the commencement of public share trading. The Exchange's inability to closely monitor the unusual activity in the market, which is still mainly rumor-driven, has also been a cause of frustration. This appears to have cast doubts in the minds of the membership on the ability of NEPSE to maintain a forum which is both efficient and transparent for the conduct of secondary market activity in corporate securities.

One of the reasons for this lack of initiative at NEPSE is the present structure of the policymaking body, which is mainly composed of non market participants, due to the government

ownership of the Exchange. When the main policymaking body is composed of non-members, such a body lacks the built-in motivation to adopt an efficient regulatory course, as they are neither accountable to its membership, nor do they have a self-interest in maintaining the Exchange as an efficient and transparent forum to trade and raise capital. The NEPSE membership at present appears to be more willing to buy into the equity of the Exchange, and the Exchange should initiate discussions with its membership to transfer the ownership of the Exchange to its members. The fairly large capital base of the Exchange may pose a problem in finding a solution in the short term. **But in the interim, we recommend an amendment to the Articles of Association of the Exchange to define the functions of the shareholders and the members of the Exchange, and their respective roles in the operations of the Exchange.**

The duties of the shareholders, at present composed of government nominees, should be confined to statutory functions, such as the approval of the annual financial statements, in view of the government ownership, while the day-to-day operations, including the policymaking, should be vested with a Board composed of market participants at a majority, to ensure greater industry participation in the decision-making process. This will pave the way for a move towards a self-regulatory structure, with the Securities Board providing oversight regulation and performing those functions that are outlined elsewhere in the report. The Exchange has already taken a step in this direction by inviting two broker members to its Board of Directors. **We recommend a suitable amendment to the Articles of the Exchange to formalize this process, and elect the broker directors of the Exchange Board through the majority vote of the members. We also recommend a seven-member board for NEPSE, which should include four members, one person nominated by the Securities Board, the Chief Executive Officer of the Exchange, and a person nominated by the government, in view of the government ownership of the Exchange. This person could function as the Chairman of the Exchange.**

4.1.3 Amendments to the Securities Regulations

The Nepal Stock Exchange, which lacks a proper set of rules to cover most areas of its operations, appears to be an organization without much independence, operating under the indirect control of the Securities Board. The proposed amendments to the regulations would, if adopted, further aggravate this situation and will make NEPSE even more dependent on the Securities Board. If the Stock Exchange is to grow in stature in the years to come and be viewed by the market participants as an effective forum for efficient and transparent market activity, it is important to grant it more independence to conduct its own affairs, by laying a proper foundation on the basis of the usually accepted principles of structuring stock markets. The role of the State regulatory body in this exercise, as we have mentioned many times before, would be to style its own regulations **requiring the Exchange to have the necessary rules in place, rather than adopting the rules themselves**, as practiced at present in Nepal. However, it would appear that with each passing day and with each new regulation NEPSE is drifting away from becoming a self-regulatory body, due to the totally ill-conceived policy pursued at present. Such a policy, if

continued unchecked, would do more damage than good to an organisation that is expected to play a pivotal role in the capital formation process of a market-based economy.

We would therefore strongly recommend that the Securities Board refrain from pursuing the proposed amendments to the securities regulations and permit the NEPSE to adopt its own LISTING, CONTINUING LISTING and ADDITIONAL LISTING rules, since the Exchange Memorandum of Association as recently amended now permit the NEPSE board to promulgate its own operating rules. Once such rules are adopted by the NEPSE they should be submitted for approval to the Securities Board, which would strengthen the position of NEPSE in enforcing them without eroding their independence.

Our observations on specific proposed amendments are as follows ;

1. Proposed amendment 19A

“Underwriting to be made : where a corporate body incorporated with the objective of carrying out industrial acts has not made the evaluation of the project for the purpose of borrowing debt from any bank or financial corporation shall issue the securities only after making the securities underwriting by the **Market-Maker**.”

The above amendment, while requiring certain entities to underwrite the issue of securities, attempts to restrict such underwriting to the market-makers. In addition to market-makers or broker dealers, underwriting services in other markets are provided by banks and other financial service companies. Any attempt to restrict the providing of such services to the market-makers while providing an unfair protection to the market-makers would also prevent other more efficient providers of such services emerging in the market, and the commission being determined by open competition in a healthy manner. **We therefore recommend that proposed regulation 19A be deleted.**

2. Proposed amendment 19B

“ Sale of shares by promoters : (1) A corporate body which has obtained permission to issue the securities pursuant to Rule 19 shall sell such securities through a person, firm or company that has obtained the Membership”.

The above amendment appears to be an attempt to restrict the issue management activity to the member firms of the Exchange. We have already commented on this provision as it also appears in the New Issue Guidelines. (Please refer our observations and recommendation under 4.1.1 -1 above, made in respect of New Issue Guideline 9A; the same recommendation should apply).

3. Proposed amendment 27A(5)b

“Where the purchase and sale have been made in less number than the minimum unit prescribed by the corporate body”

The above amendment refers to an instance where a corporate body listed on the Exchange could refuse to register a share transfer in the books of the company. The minimum board lot for trading on the floor is determined by the Exchange and not by the company. The manner in which the above amendment is worded gives the impression that the minimum board lot is determined by the company, which is misleading. Stock Exchanges the world over, including NEPSE at present, permit ‘odd lots’ to be transacted on the floor. The above amendment will prevent ‘odd lots’ from being transacted on the floor, which would cause numerous hardships to holders of such shares. On occasion there may also be investors who wish to buy odd lots in the market to round off already existing parcels held by them. The above amendment would prevent the acquisition of odd lots by such investors. **We therefore recommend that the above amendment be deleted.**

4. Regulations 22 to 27 in the existing regulations (Chapter 5) relate to the listing of securities. These regulations together with any amendments to same should form part of the NEPSE rules on listing. **Hence we recommend that they be repealed from the Securities Board regulations permitting NEPSE to adopt its listing rules.**

5. Regulations 28 to 34 in the existing regulations (Chapter 6) relate to the Membership Rules of a Stock Exchange. These regulations may have been adopted by the Securities Board at a time when the NEPSE could not promulgate any rules due to the absence of a rule making provision in the Exchange Memorandum of Association. **Since this has now been rectified, we recommend that Regulations 28 to 41 be deleted from the Regulations of the Securities Board and, together with the proposed amendments, be adopted by the NEPSE as its membership rules.**

We also recommend that a suitable provision be included in such membership rules to subject the grant of membership by the Exchange subsequent to a license of membership being issued by the Securities Board. As recommended earlier in the report, the Securities Act should be amended to enable the Securities Board to license the Exchange members in addition to the already existing function of licensing Stock Exchanges.

The regulations of the Securities Board in addition to those appearing in chapters 3, 4 and 7 should cover the following areas:

1. Regulations for the licensing of the Exchange members and the renewal of such licenses.
2. Provisions for the licensing of underwriters and the regulation of their activities.

3. Provisions for the licensing of unit trusts and mutual funds and the regulation of their activities.
4. Provisions to curb insider trading, preferably in the main enactment.

4.2 Market Structure

The market structure has undergone very few changes from its earlier position. Member brokers of NEPSE have formed themselves to an association basically with the objective of promoting their professional interests.

4.2.1 Brokers' Association

The prime mover of the association is a group of approximately ten members of NEPSE who display a great deal of initiative and perseverance in their profession, and aggressively pursue their objectives as members of the Exchange. From a performance standpoint, an improvement in the skill level of the brokers is clearly evident. They have a better understanding of the market and the market concepts. If nurtured with proper guidance, this group could develop into the core group of professionals responsible for the further advancement of the Exchange. It may be worthwhile to consider extending some assistance to the association to develop it on the lines of an SRO (Self-Regulatory Organisation), as the interests of the association members are closely interconnected with those of the State regulatory body and NEPSE (i.e., enhancing investor confidence in the marketplace and making it more efficient). The major objectives of such an association should be the establishment and maintenance of professional and ethical standards among its members; protection of member interests; promotion of the development of the securities market through member participation in drafting common operating procedures; creation of legislative acts, rules, and regulations and ensuring members' compliance with them; enhancement of the awareness of its membership about industry-specific topics through training programs; and provision of legal services to the members. Such an involvement by the association would complement some of the efforts of the Securities Board and NEPSE in monitoring the activities of the member firms of the Exchange and their employees.

4.2.2 Market Makers

However, from a performance standpoint, the same could not be said for the other segments of the market structure. The market-makers, introduced in the initial stages of trading at NEPSE with the intention of providing liquidity to the market, have turned out to be a dismal failure. Their contribution to the trading volume of the Exchange even from the early stages was minimal, and questions were raised in many circles with regard to their relevance in the Nepal capital markets.

In markets where they exist, the market-makers function as 'wholesalers,' always carrying a stock of shares and quoting two-way prices. Their presence would ensure liquidity and depth in a market, guaranteeing a ready buyer and a seller for a security at any given time. To obtain the benefits of a market-maker system it is imperative to ensure that the market-makers are liquid in terms of shares in order to be ready sellers, and in terms of cash in order to be ready buyers. However, when NEPSE introduced market-makers from the inception in January 1994, neither of these pre-conditions were fulfilled and it was doomed to fail--hence the outcome we witness today after two years of operations.

Hardly any representatives from the market-making firms were present on the floor during trading hours during our visit in mid-August, and on making inquiries we were made to understand that it is more the norm than the exception. The main reason for the failure of the market-makers was the inability of the market-makers to acquire a sufficient buffer stock of shares initially required by them for market-making. Even if they managed to acquire a buffer stock it would appear unlikely that the market-makers could have made an impact in the market, due to the continued lack of liquidity in the market place. In this regard we quote below from our report of August 1993;

"It would therefore, be in the interest of the Exchange to consider activating the 'market-maker' provisions in the securities regulations after the market has developed much greater liquidity, both in terms of cash and stocks, when the Exchange and the Securities Board are better placed to enforce an effective surveillance and enforcement procedure, and when a more regular flow of information is forthcoming from the listed companies. There is substantial precedent for this more gradual approach. These categories of participants in most other markets have permitted to evolve over a period of time. Their presence is usually dictated by market developments rather than regulatory requirements."

We therefore recommend that the NEPSE initiate steps to convert the market-making companies to stock brokering companies, as the necessary pre-conditions for the functioning of market-makers are not present in the Nepal capital market environment. The presence of such pre-conditions in the foreseeable future appear to be rather remote.

4.2.3 Mutual Fund Operations

A crisis situation has also developed in the area of Mutual Fund operations. The NCM First Mutual Fund 2050, which commenced operations as an open-end mutual fund in July 1993, even prior to the opening of public share trading at the NEPSE, has suspended the redemption of units by the management company in July 1995, citing liquidity constraints. Here again it was another example of attempting to create a capital market institution well prior to the need for such an institution. A fairly well developed secondary market with a sufficient pool of potential investment opportunities and liquidity, a reasonable number of market players with adequate

holding power to withstand a prolonged downward trend in the market, and a reasonably sophisticated investor community are necessary pre-conditions to the launch of an open-end mutual fund. The initial seed capital requirements for the launch of such a fund have never been met by the promoters, which further aggravated the liquidity situation of the fund. It would appear that the advertisements published by the promoters in the run-up to the launch of the mutual fund and subsequently towards the latter stages of 1994, as well as certain terminology used in the prospectus ("Handsome returns"), may have contributed to the creation of false expectations with regard to anticipated returns in the minds of the investors. A number of factors contributed to the crisis which developed at the NCM First Mutual Fund 2050, among them a large pool of investible funds; insufficient investment opportunities coupled with initial high expectations in the minds of the investors, who were less forthcoming as the market operations of the fund progressed; and the lack of initial capital contributions by the fund's promoters.

We give below a more detailed evaluation of the developments at the NCM First Mutual Fund.

In terms of the prospectus, the NCM First Mutual Fund 2050 floated in July 1993 is an open-end fund. The term 'open-end' is derived from one of the main features of such a fund, where the upper limit of the fund is not defined by the promoters at the time of the inception. The size of the fund could expand and contract during its lifetime, based on the purchases and sales to and from the fund, subsequent to the initial subscription period. The exit mechanism for the unit holders in an open-end fund is through the sale of units back to the management company, as opposed to selling through the Stock Exchange as in the case of a closed-end fund.

During the initial subscription period (1st July to 27th August 1993), the fund had collected approximately 30 million Rupees from the public at the rate of Rupees 10 per unit. Since commencing its investments, and with the increased activity at the Stock Exchange, the purchase of new units by the public had been brisk during June - November 1994. This resulted in the expansion of the fund size and its unit holder base. The subsequent purchases of units have been at prices ranging from Rs.10 to Rs.15.

With the decline of the stock market in early 1995, the re-purchase price of units by the fund from the public (calculated on the basis of net asset price of the unit at the end of each trading day) had declined. A large number of unit holders (approximately 800) opted to sell back the units to the fund during this period, which resulted in the erosion of its liquidity. In July 1995 the fund had suspended the re-purchase of units from the public, which is a violation of the terms of issue as outlined in the prospectus.

In view of the above developments the fund contemplates a listing on the Stock Exchange. Given the features of the fund, such a step is purely an academic exercise which would not absolve the management company from its obligation of re-purchasing of units from the unit holders who wish to exit from the fund.

The management company proposes two options to overcome the present crisis:

1. Convert to a closed-end fund and obtain a listing on the Stock Exchange.
2. Liquidate the fund.

Liquidation of the fund at a time of a market slump would result in a further collapse of prices in the stock market, as the market lacks sufficient depth to absorb a large portfolio of shares. Such a step may also result in the company succeeding in disposing of only the more attractive shares in the market. In case of such an event, the unit holders would suffer heavy losses which would have a disastrous effect on the further development of capital markets in Nepal. Hence the only option left would be to convert the fund to a closed-end fund and obtain a listing on the Stock Exchange.

However, in view of the re-purchase obligations cast on the fund in terms of the prospectus, such a step should only be initiated with the consent of the unit holders of the fund at a meeting of the unit holders convened for that purpose, to protect the management company (NIDC Capital Markets) from future legal action by the unit holders. In order to avoid any negative implications on future market development in the country, it is also recommended that the management company make arrangements to re-purchase units of dissenting unit holders at a price to be determined in consultation with the Securities Board.

As at the time of suspending redemptions, the fund had a membership of 1756, holding 5,269,800 units. The purchase prices of such units vary between Rs.10 and Rs.14.59. The prices paid for a unit by the remaining unit holders, and the relative percentage of unit holders who have paid such prices, are given below.

<u>Unit Price (Rs.)</u>	<u>Percentage</u>
10	31
10 - 11	21
11 - 12	1
12 - 13	15
13 - 14	14
14 - 15	18

Prior to listing closed-end investment funds, NEPSE should formulate a set of rules stipulating the criteria for the approval of such funds. These rules inter alia should cover the following:

1. Minimum issued capital of the investment company (at least Rs.50 Million for the time being).
2. Business standing, competence and the track record of the directors of the investment company and the management company.
3. The spread of investments in the portfolio.
4. The maximum limits applicable to the value and the size of individual investments.

5. The limits applicable to, both in terms of monetary value in relation to investible funds and as a percentage holding of shares, investments in unlisted securities and the basis of valuation for such investments.
6. Limits applicable to investments in related (subsidiary, associate) companies of the major shareholders of the investment company, management company or the investment advisors.
7. Proper safeguards in the Articles of Association of the investment company to ensure that the management of the investment fund is done in a manner that will equally benefit all shareholders of the fund.
8. Provisions in the rules to ensure that the management of the investment company is entrusted to a independent party unrelated to the substantial shareholders whenever a person, group or company holds a substantial percentage (20% or more) of shares in the investment company.

4.2.4 Institutional Investors

The institutional investors constitute an important aspect of the market structure. These investors facilitate the participation in the stock market of small investors who could not otherwise not have done so due to their meager resources, by pooling their savings and diversifying the risk. The investors also bring about a stabilizing effect on the market with their longer-term outlook in their investment strategies. The role of institutional investors would be even more important in countries with a lower rate of savings, and every effort should be made to encourage their participation in the stock market. However, in the context of the Nepal market, the participation of institutional investors appears to be rather minimal, which has caused some concern among the other market participants. Although the absence of institutional investor participation in a market could be due to a variety of reasons, there appears to be a firm perception within the industry in Nepal that the treatment of capital gains made by institutional investors as normal income, subject to a tax of 30%, could be a major contributory factor. In most other emerging markets, during the initial stages of market development, such gains were considered as capital gains and were either exempt from taxation or were taxed at a very nominal rates (2.5%-5%) in order to encourage greater institutional participation in the market. Expanding capital markets in turn would create greater employment and income-generating opportunities in the economy, thus mitigating the loss of revenue due to exempt or reduced taxation. Capital gains is usually viewed as a tax which is biased against foreign investors, since such investors, if subjected to a capital gains tax in the country of investment, have no means of claiming capital losses incurred in that country. Markets with plans of attracting foreign investors should therefore be wary of introducing such a tax, even at nominal rates.

We therefore recommend that both the Securities Board and the NEPSE study the impact on the institutional investor participation in the market of the treatment of capital gains as normal income subject to a tax of 30%. Based on the findings of such a study, recommendations should be made to the relevant authorities for any corrective action.

4.3 Market Operations

4.3.1 Stock Exchange

A noticeable improvement in the operation of the Stock Exchange is the computerized record-keeping of the trading, clearing and settlement information of the Exchange. Mainly based on formats designed in January 1994, with necessary amendments to suit subsequent changes in operational aspects, the switch to computerized record-keeping has provided the Exchange management with a better handle on monitoring the activities of the members. As a result, there has been a commendable improvement in curbing the initiation of sale transactions without possessing valid sale documents, and in reducing the accumulation of liabilities over and above the permissible limits and the collection of settlement dues from member firms. In addition to maintaining the information required to supervise the activities of the member firms in a more efficient manner, the success in the better regulation of selected aspects of member post-trade activities is also due to the willingness displayed by certain managers of the Exchange to initiate action against errant brokers in a timely manner. However, hardly any progress has been made in the area of member surveillance, which is one of the most important areas in the post-trade activities of the membership.

Another area of operation where much is yet to be achieved is market monitoring and surveillance of listed companies. This has resulted in the persistent non-disclosure of information of a material nature by the listed companies, and the continued erratic movement of share prices, resulting in financial losses to unwitting investors, which has caused considerable amount of loss in confidence in the Exchange management among the membership as mentioned in Section 1.2 of this report. In addition to the possible (mainly internal) reasons already identified in the same section for this breach of confidence, there appear to exist certain conflicts of interests in the involvement of the Exchange, which cast serious doubts on its ability to perform its intended functions without any fear or favor. A clear example of the existence of a conflict of interest is the shareholding of NEPSE in the Citizens Investment Trust (CIT), an organisation which is regulated by the Exchange, and the Exchange CEO functioning as a member of the CIT board and not vice-versa. NEPSE should not hold equity in any organization and compromise its position as a regulator. As a regulator it should not only do what is correct, but should also be seen to be doing what is correct by other market participants. This is the reason why Stock Exchanges confine the investment of any surplus funds to government securities.

Such conflicts of interest at the Exchange exist mainly due to historical reasons. Both the securities board and the NEPSE are creations of the Ministry of Finance, and the ownership of NEPSE is in the hands of a handful of government organizations. In such scenarios, organizations

which are created by a single Ministry are likely to have cross- holdings of ownership in each other. As a short-term measure of overcoming this conflict of interest, which compromises NEPSE's position as a regulator, the Exchange should divest its shareholdings in CIT and other similar organizations which are likely to come under its regulatory purview. As a longer term solution--as this problem is likely to recur in many different forms in the future--the Ministry of Finance should initiate steps to divest the State ownership in NEPSE to its membership. In discussions we had with the members of NEPSE during our recent visit, a greater willingness was evident among the membership to be the owners of NEPSE.

Once the Exchange functions as a member-owned entity, the CEO of the CIT will always get an opportunity to be on the NEPSE board, as would so many others. In such a scenario, the members themselves will formulate the rules and set the standards. This is the essence of self-regulation, which we have been recommending throughout our involvement with NEPSE. In a self-regulatory environment the board of the Exchange will always be majority-controlled by the members of the Exchange. The checks and balances in such cases are provided by non-member directors, nominated either by the State or elected by the shareholders from among the financial community, as in most other emerging and developed Exchanges, including the New York Stock Exchange. The State regulatory body also gets involved in approving all rules, systems and procedures adopted by the Stock Exchanges, which would prevent Exchange members from adopting unfair practices.

4.3.2 Multiple Functioning

Multiple functioning in the areas of stock brokering, portfolio management, and market making is a natural development in many markets with the expansion of capital markets, and is another instance where conflict of interest situations could arise. Although it is not uncommon for such functions to be performed under the same roof in other developed and emerging markets it is important to ensure that “Chinese Walls” (separate subsidiaries for different functions with different people responsible for these functions) do exist prior to permitting such functions under a single roof. The market in Nepal has not yet attained the level of volume required to effectively practice the concept of “Chinese Walls”. Under such circumstances, and in an environment where a NEPSE mechanism for the surveillance of the member firms is seriously lacking, there is a greater possibility for abuses to occur if such conflicting functions are permitted to be carried out under the same roof at the present stage of development of the market in Nepal. Unfair access to market information, unfair preference in the execution of client orders and unfair allocation of shares among clients would be some of the abuses which could take place if multiple functioning is permitted without a sound Exchange surveillance mechanism and proper demarcation of functions, both of which are difficult propositions in Nepal at present.

Another area of concern in the Nepal capital markets is the involvement of stock brokers as auditors of listed companies. Such dual capacities would provide the brokers concerned an unfair advantage over their colleagues in access to the financial information of the listed companies. In order to provide a level playing field to all members of NEPSE, the Exchange

should require its membership to disclose to the Exchange such conflicts of interest so that remedial action could be initiated.

In instances where brokers are involved as auditors of listed companies, we recommend that they be precluded from acting as stock brokers in the securities of those companies.

4.3.3 Admission of New Members

The membership of NEPSE has increased by five during the past fifteen months. In recruiting members NEPSE has made no effort to levy an entry fee from the new members. The entrance fee is one among many sources of revenue available to a Stock Exchange. New members approach the Exchange for membership since they believe that the Exchange membership would provide them with an opportunity to make profits. Such opportunities have been made possible due to the investments made by the Exchange in the past in developing its systems and procedures. Unless the reserves of the Exchange are replenished at regular intervals to service the expanding needs of its members and the market place, an Exchange would find it difficult to maintain its competitiveness as a viable forum to attract capital to the economy. **We therefore recommend that the NEPSE consider levying an entry fee on all future entrants to the Exchange.** However, the determination of the entry fee could always be a debatable issue, with the existing members inclined towards maintaining it at a higher level in order to discourage competition from the new entrants. The new entrants, on the other hand, would prefer to gain access to an income-generating avenue at the lowest cost. In view of the rather subjective nature of the determination of such fees, NEPSE should obtain the approval of the Securities Board prior to the implementation of the entry fee. Such a step would protect NEPSE from being accused of creating harmful entry barriers to the Exchange.